THE WALL STREET JOURNAL.

A Recession, if It Comes, Could Be Worse Than Those of Recent Past

January 22, 2008

The U.S. has suffered recessions only twice in the past quarter century, and both were short and mild. But there are good reasons to fear that the looming recession, if it arrives, could be worse.

Housing is in the midst of its worst downturn since at least the 1970s. That has led to a meltdown in the nation's mortgage market; with financial firms struggling to make sense of their losses, they are making it harder for even credit-worthy borrowers to get loans. The combination of heavy debt loads, still-high energy and food prices and a weakening job market has households tightening their belts. Consumer spending, long a bulwark of the economy, is faltering.

That sets the stage for something more severe than the 2001 recession, which spanned just eight months, says Merrill Lynch economist David Rosenberg. During that slump, in which gross domestic product declined by a slight 0.4%, quarterly consumer spending slowed but never contracted -- the first time that happened during a recession since the 1940s.

The eight-month recession that ended in early 1991, when a housing downturn and credit problems sapped the economy, is a better guide. From its peak to its trough, GDP shrank 1.3%, and consumer spending slipped.

Today's housing debacle is even worse, says Mr. Rosenberg, and the financial crisis it has precipitated is far more severe.

University of Maryland economist Carmen Reinhart and Harvard University economist Kenneth Rogoff agree. They say the current crisis appears on track to be at least as bad as the five most catastrophic financial crises to hit industrialized countries since World War II.

If those past experiences are any guide, the economy is in trouble, they argue in a recent paper. Indeed, "if the United States does not experience a significant and protracted growth slowdown, it should either be considered very lucky or even more 'special' than most optimistic theories suggest," they write.

One reason that large crises inflict so much damage is that financial institutions have a hard time getting a handle on how bad their losses will be, and that uncertainty makes them less willing to lend. Citigroup Inc. and Merrill Lynch & Co. each reported billions of dollars in losses last week that were in addition to the billions in losses they reported in the fall. Citigroup said it was building its loan-loss reserves for auto loans and credit-card debt, in addition to mortgages, and that it was tightening credit-card lending standards.

"Part of the problem is just not knowing," Ms. Reinhart says. "The longer the process of not knowing what the losses are takes, the longer the resolution takes." Japan was the extreme example, she says. Japan's inability to appropriately gauge the losses from the collapse of its 1990s real-estate and stock bubble led to a "lost decade" of economic growth.

A critical difference between the U.S. and Japan is that the Federal Reserve has been cutting the target for its benchmark federal-funds rate and appears ready to cut it more deeply, whereas the Bank of Japan was still raising rates a year after Japan's bubble began to collapse. Also, Congress and the White House are both promising a fiscal-stimulus package, with Fed Chairman Ben Bernanke pushing for a plan that would help boost spending this year.

Businesses, at least those outside of the banking and housing sectors, might also take some of the sting out of a recession. Their finances are in far better shape now than they were in 2001, and credit so far is still widely available. As they repaired their balance sheets in the wake of the 2001 recession, companies were also slower to hire than in past economic expansions. That may mean they won't be able to cut jobs as deeply, says Goldman Sachs economist Jan Hatzius.

Robert Gordon, an economist at Northwestern University who is also a member of the National Bureau of Economic Research committee that determines (usually long after the fact) when recessions begin, is hopeful that overseas growth may continue to bolster the U.S. economy. He notes that exports, which have been growing rapidly and account for more than twice as large a share of GDP as home construction does, will continue to post strong growth, easing the pain of the housing decline.

Still, he thinks a recession is probably coming and that the challenges facing consumers, in particular, are more severe than they were in the two previous downturns. In addition to the housing troubles and mortgage-market woes, higher food and energy costs are cutting into household budgets, he says.

"While energy is not as important a part of the consumer budget as it was in the '70s -- nor is food -- nevertheless, the squeeze will push out consumption in everything else," Mr. Gordon says. "Across the board, I think we're going to have significant ongoing pressure in inflation-adjusted retail sales."

Robert Barbera, an economist at New York trading-services firm Investment Technology Group Inc., agrees. "Consumers will be part of this recession in a way that they weren't in 2001," he says.

Even if the country is in for just a mild recession, the pressure on spending, coupled with what has happened in the housing and mortgage markets, may make it feel a lot worse for most Americans than the past two downturns did.